(2)

No. 88-93

Supreme Court, U.S.
FILED
AUG 15 1988
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

UNION PACIFIC RAILROAD COMPANY, *et al.*,
Petitioners,

v.

TERRY F. MORITZ, TRUSTEE OF
IOWA RAILROAD COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

---

BRIEF OF THE ASSOCIATION OF AMERICAN RAILROADS AND THE AMERICAN SHORT LINE RAILROAD ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF THE PETITION

THOMAS C. DORSEY
The American Short Line
Railroad Association
2000 Massachusetts Avenue, N.W.
Washington, D.C. 20001
(202) 785-2250

J. THOMAS TIDD
KENNETH P. KOLSON *
Association of American
Railroads
50 F Street, N.W.
Washington, D.C. 20001
(202) 639-2511

August 15, 1988

* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
INTEREST OF THE AMICI CURIAE	1
SUMMARY OF ARGUMENT	4
ARGUMENT	6
I. The Court of Appeals Finding That the Interline Freight Balances At Issue Constituted "General, Unsecured Debts" of the Bankrupt Iowa Railroad is Totally Unsound as a Matter of Federal Bankruptcy Law and Conflicts With Decisions of the Third and Sixth Circuits That Properly Treat Interline Freight Balances as Trust Funds	6
A. Background—The Interline Freight Balance System	6
B. The Third and Sixth Circuit Decisions Treating Interline Freight Balances as Trust Funds in Railroad Bankruptcy Proceedings	10
C. The Decision of the Seventh Circuit Below Treating Interline Freight Balances as "General, Unsecured Debts" of the Bankrupt Conflicts with the Third and Sixth Circuit Decisions and Will Create Serious Problems for the Railroad Industry if Not Reversed	16
CONCLUSION	27

TABLE OF AUTHORITIES

Cases Page

Atlantic Coast Line R. Co. v. *Pennsylvania & Co.*, 12 F.Supp. 720 (E.D. Pa. 1935) 24

Chase v. *Committee of Interline R.Rs. (In re Ann Arbor R.R. Co.)*, 623 F.2d 480 (6th Cir. 1980) ....*passim*

In re Lehigh and New England Ry. Co. (Appeal of Central Jersey Indus., Inc.), 657 F.2d 570 (3rd Cir. 1981) 20, 26

In re Penn Central Transp. Co., 486 F.2d 519 (3rd Cir. 1973) (en banc), *cert. denied*, 415 U.S. 990 (1974) .....*passim*

Southern Ry. Co. v. United States, 306 F.2d 119 (5th Cir. 1962) 21

Statutes and Regulations

49 U.S.C. § 10703 6

49 U.S.C. § 10705 .....4, 7, 13, 24

49 C.F.R. § 1201(A)(1-1) 2

Other Authorities

Restatement (Second) of Trusts (1957) 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-93

UNION PACIFIC RAILROAD COMPANY, *et al.*,
Petitioners,

v.

TERRY F. MORITZ, TRUSTEE OF
IOWA RAILROAD COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

---

BRIEF OF THE ASSOCIATION OF AMERICAN RAILROADS AND THE AMERICAN SHORT LINE RAILROAD ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF THE PETITION

INTEREST OF THE AMICI CURIAE [1]

The Association of American Railroads ("AAR") is the trade association for the nation's larger railroads.

[1] All parties have consented to the filing of this brief pursuant to Rule 36 of the Supreme Court rules. Letters signifying consent have been filed with the Clerk.

Its membership includes essentially all Class I railroads [2] and numerous non-Class I railroads. Its members account for approximately 93 percent of the freight revenues of all railroads in the United States. The American Short Line Railroad Association is the trade association for more than 300 small railroads, the vast majority of which are Class III railroads. Both the AAR and the ASLRA represent their member railroads before courts, agencies and the Congress in matters of common concern.

The decision below raises an important issue of common concern to the railroad industry—to both large and small rail carriers alike. At issue is the status under federal bankruptcy law of "interline freight balances," which are essentially funds representing freight revenues collected from shippers or consignees by one railroad participant to an interline movement of freight (*i.e.*, a movement involving the interchange of freight between two or more carriers) as collection agent for the other participating carriers for their portion of the freight charges. The district court in this case, relying on prior decisions of the Third and Sixth Circuits holding such interline balances to be trust funds, found that approximately $4 million in interline freight balances collected by the Iowa and not settled at the time of the Iowa's bankruptcy petition were held in trust (to the extent still in the possession of the Iowa) for the benefit of the carriers who earned the freight revenues.[3] In the deci-

---

[2] Under carrier classifications adopted by the Interstate Commerce Commission, a Class I railroad is defined as a carrier with annual operating revenues of $50 million or more. A Class II carrier has annual operating revenues of less than $50 million but more than $10 million. A Class III carrier has annual operating revenues of $10 million or less. (The annual revenue figures are adjusted for inflation.) 49 C.F.R. § 1201(A)(1-1)(a)-(c).

[3] Of the $4 million in interline freight balances at issue, $1.4 million was collected by the Iowa on behalf of petitioners; the balance was collected on behalf of other railroads.

sion for which certiorari is sought, the Seventh Circuit, finding that the requisites of a state law trust could not be satisfied with respect to the interline freight balances at issue, reversed the district court and held that the interline freight balances at issue were merely "general, unsecured debts of the Iowa" and that the revenues generated by such balances must accordingly be made available to all of the Iowa's general creditors.

If the decision of the Seventh Circuit is allowed to stand, and the status of interline freight balances collected by one railroad on behalf of another under established industry practice is to be relegated to that of an ordinary trade debt in railroad bankruptcy proceedings, the potential adverse revenue impact upon the railroad industry would be enormous. Of the approximately $26 billion earned by Class I railroads in 1987, approximately 54 percent, or $14 billion, constituted interline revenue whose recovery would be placed in jeopardy in bankruptcy proceedings by the decision of the court below. In addition, because the decision below strikes directly at established industry practice with respect to the collection of interline freight charges by a single carrier, it has the potential to significantly and unnecessarily complicate interline operations between carriers, particularly where short line carriers (virtually *all* of whose earnings is derived from interline operations) currently act as collection agent. The railroad industry submits that there is neither warrant in law, equity nor policy to treat funds earned by rail carriers in interline operations as property of the collecting road in bankruptcy proceedings, and such result should not be countenanced by this Court in the interests of sound federal bankruptcy law applicable to the rail industry.

Moreover, because the decision below conflicts with decisions of the Third and Sixth Circuits with respect to the status of interline freight balances in railroad bankruptcy proceedings, the uncertainty and lack of national

uniformity fostered by the decision below provides strong additional grounds for industry-wide concern. The AAR and the ASLRA, on behalf of the railroad industry, therefore strongly support the petition for a writ of certiorari.

SUMMARY OF ARGUMENT

The national rail system is dependent on interline service between connecting carriers for its very existence. Rail carriers are in fact *required* by the Interstate Commerce Act to establish "through routes" with each other to enable the interconnecting properties of independent carriers to operate as a single, unified national rail network. 49 U.S.C. 10705. In order to facilitate the efficient movement of freight in interline service, the rail industry has established specific procedures for the collection and settlement of freight charges. Under those industry-wide procedures, freight charges are collected from shippers or consignees by either the origin or destination carrier, which acts as the collection agent of the other participating carriers for their portion of the freight charges. Freight charges owed to participating carriers by the collecting carriers for their portion of interline movements ("interline freight balances") are settled after the close of each month; a carrier with a net balance to its credit may draw a "sight draft" upon the bank account of a carrier with a net debit balance (the payment system required under the AAR's rules and voluntarily subscribed to by approximately 250 smaller roads) or may request payment by direct billing (the "bill and voucher" method) (the method used by approximately 230 smaller roads, including the Iowa Railroad at the time of its bankruptcy).

Prior to the instant case, pursuant to the decisions of the Third Circuit and the Sixth Circuit, interline freight balances in the possession of a bankrupt carrier were considered "trust" funds held by the bankrupt collecting

carrier for the benefit of the interline carriers who earned the freight charges. In the instant case, the Seventh Circuit found that interline freight balances settled pursuant to the "bill and voucher" method were *not* held in trust for the interline roads that earned the revenue but were merely "general, unsecured debts" of the bankrupt.

In so holding, the Seventh Circuit rejected the specific factors relied upon by the Third Circuit and Sixth Circuit in their determinations that the manifest intent of the participants to the interline freight settlement system was to establish a trust relationship rather than a debtor/creditor relationship for interline freight balances. The Seventh Circuit also squarely rejected the holding of the Sixth Circuit that interline freight balances should be held to be trust funds as a matter of law because such result was necessary to ensure the viability of the national rail system.

Because the decision of the Seventh Circuit directly conflicts with the decisions of the Third and Sixth Circuits, review by this Court is necessary to ensure a uniform national rule for the treatment of interline freight balances. Moreover, because the decision of the Seventh Circuit has the potential to seriously disrupt interline freight movements and place in jeopardy substantial rail industry revenues, review by this Court is also necessary in the interests of ensuring an efficient national rail transportation system.

ARGUMENT

I. The Court of Appeals Finding That the Interline Freight Balances At Issue Constituted "General, Unsecured Debts" of the Bankrupt Iowa Railroad is Totally Unsound as a Matter of Federal Bankruptcy Law and Conflicts With Decisions of the Third and Sixth Circuits That Properly Treat Interline Freight Balances as Trust Funds

A. *Background—The Interline Freight Balance System*

The majority of the over $26 billion in revenue earned by the railroad industry in 1987 (as a representative year) was earned through interline operations, *i.e.*, the carriage of goods from origin to destination over the lines of more than one carrier. These interline operations are the result of both practical necessity and statutory obligation. The existing national rail network is made up of thousands of miles of individual railroad lines separately owned by hundreds of independent railroad companies. Although service over a single company's line can serve a multitude of origin and destination points throughout the United States, true nationwide service requires the cooperation and interchange of freight between the nation's carriers. Indeed, there currently does not exist, and never has existed, a single railroad system capable of serving both the Atlantic and Pacific coasts of the continental United States through its own rail lines, much less service to all intermediate points throughout the nation.

Nationwide interline rail service is also required as a matter of statutory compulsion. Under the Interstate Commerce Act, rail carriers are required to "establish through routes with each other and . . . rates and classifications applicable to those routes." 49 U.S.C. 10703 (a)(1). In addition, the Interstate Commerce Commission is empowered under the Act "when it considers it desirable in the public interest, [to] prescribe through

routes, joint classifications, joint rates . . ., the division of joint rates, and the conditions under which those routes must be operated" for interstate rail carriers. 49 U.S.C. 10705(a)(1). Such statutory requirements ensure as a matter of law that the nation's rail system acts as a single integrated network for the interstate movement of freight and render unnecessary the wasteful duplication of rail lines that would otherwise result from the absence of a requirement for nationwide interline service.

The railroad industry has developed standard industry practices to facilitate the prompt and efficient movement of goods in interline service. Perhaps the most important of such industry practices relate to procedures for the collection and settlement of freight charges between the several participating carriers to an interline rail movement, which practices are designed to ensure that each railroad participant promptly receives the portion of the revenues it earned through interline operations while facilitating the payment of freight charges by shippers or consignees (and the interline movement of freight generally).[4]

Charges for interline freight movements are established by carrier participants on either a joint or individual basis. A "joint rate" is a rate established pursuant to the agreement of two or more carrier participants to the interline movement (or pursuant to Commission prescription under 49 U.S.C. 10705) and is applicable to all origin and destination stations covered by the agreement. Each participant's share in the joint rate (the "division") is similarly established by joint carrier agreement (or

[4] Other railroad industry practices for the payment of interline accounts relate to (1) per diem charges (*i.e.*, a charge for the use of another's railroad cars) (2) switching charges; (3) overcharges and car repairs; (4) loss and damage charges; and (5) miscellaneous bills. These accounts essentially involve services provided by carriers to other carriers and do not involve the collection of funds by one carrier acting as agent for another.

Commission prescription). Rates for an interline movement can also be established as the sum of individual carrier rates applicable to the local line segments traversed (*i.e.*, the sum of "proportional" or "local" rates separately established by the carrier participants and which apply only to their individual line segments).

Regardless of whether interline rates are jointly set or are the sum of combinations of individual rates, industry-wide practice and procedure governing the collection and settlement of interline freight charges provide for a simplified mechanism whereby either the origin or destination carrier acts as agent of the other participating carrier or carriers in collecting freight charges from the shipper or consignee and in remitting to the other participating roads the portion of the freight charges earned by them. The industry's collection and settlement procedure is designed to obviate the necessity of a shipper or consignee making multiple payments to multiple roads for a single shipment and concomitantly to facilitate the prompt interchange of traffic between participants to the literally tens of thousands of interline movements that occur during each monthly settlement period.

The industry-wide "interline freight balance" settlement procedure functions as follows. When a shipment moves in interline service, a single carrier, either the originating carrier (if it is a "prepaid" shipment) or the destination carrier (if it is a "collect" shipment) collects the freight charges from the shipper or consignee on behalf of all carrier participants to the movement; *i.e.*, the originating or destination carrier acts as the collection agent for the other participating roads with respect to their share of the interline freight charges. Regardless of which carrier collects the freight charges, however, the destination road is responsible for preparing and settling the interline freight accounts.[5] At the

[5] The destination carrier is assigned the interline settlement function because it alone is informed of the final routing of an inter-

close of each month, the destination carrier, based on the final "waybill" (or movement record) information for each interline shipment, prepares an "abstract" of each waybill and a summary of all waybill abstracts ("summary of interline accounts of freight received") for the month indicating the amounts owed to (or due from) each carrier participant to an interline movement based on the applicable revenue share and the amounts collected (or to be collected) by that carrier. The interline account summaries are exchanged between participants to interline movements no later than the 14th working day of the month after the freight movement is completed and the waybill information is available. Using these statements, and offsetting the amounts shown, each participating carrier calculates the monthly "interline freight balance" resulting between it and each carrier with which it interlined shipments.

The resulting interline freight balances are payable to the carrier that earned the freight charges either through "sight draft" or through direct billing. Under the "sight draft" procedure, which is required under the AAR's accounting rules for AAR members and which is voluntarily subscribed to by approximately 250 smaller railroads, a railroad with a net balance to its credit prepares an electronic bank draft for the amount due (via a microencoded card) and sends it to the debtor's bank which is authorized to pay the electronic draft in the ordinary course of business. Under the direct billing ("bill and voucher") method (which is used by approximately 230 smaller roads and which was used by the Iowa Railroad at the time of its bankruptcy), a bill for the amount due is prepared by the road with the net balance in its favor and is forwarded for payment upon receipt to the road with the net debit balance.

---

line movement, including the carriers participating in the movement and each participant's revenue share.

B. *The Third and Sixth Circuit Decisions Treating Interline Freight Balances as Trust Funds in Railroad Bankruptcy Proceedings*

The status of outstanding interline freight balances presents an issue of paramount importance in the context of a railroad bankruptcy proceeding. Often, interline freight balances in the possession of a bankrupt carrier at the time of a bankruptcy petition—particularly a small origin or destination carrier (such as the Iowa Railroad) that participates in only a small portion of an interline movement yet collects substantial sums due other participating carriers—is targeted as *the* major potential source of funds by the general creditors of the bankrupt carrier, even though such funds have neither been contributed by the general creditors themselves nor represent freight revenues (nor other funds) generated by the bankrupt carrier on its own behalf. Should these funds representing outstanding freight charges collected on behalf of other carriers be held to be general assets of the bankrupt's estate, the interline carriers who actually earned the funds and on whose behalf the funds were actually collected would stand to lose virtually all of the substantial interline revenue involved, to the benefit of the general trade creditors of the bankrupt, who would thereby gain an undeserved windfall.

In considering the status of interline freight balances in the context of railroad reorganization proceedings under the federal bankruptcy laws, both the Third Circuit (*In re Penn Central Transp. Co.*) ("*Penn Central*"), 486 F.2d 519 (3rd Cir. 1973) (en banc), *cert. denied*, 415 U.S. 990 (1974)) and the Sixth Circuit (*Chase* v. *Committee of Interline R.R.s (In re Ann Arbor R.R. Co.)*) ("*Ann Arbor*"), 623 F.2d 480 (6th Cir. 1980) have squarely found that such balances are *not* general assets of the collecting road that must be made

available to its general creditors in bankruptcy proceedings but instead represent amounts *held in trust* by the bankrupt collecting road for the benefit of the interline carriers that earned (and are entitled to) the freight charges constituting the balances. The grounds for the Third and Sixth Circuit decisions are firmly predicated in law, equity, and federal policy underlying the Interstate Commerce Act and the bankruptcy laws.

The landmark case with respect to the appropriate treatment of "interline freight balances" as trust funds in railroad bankruptcy proceedings is the en banc decision of the Third Circuit in *Penn Central* (both the majority opinion and the concurring opinion of Judge Adams). In *Penn Central*, the Third Circuit was faced with the issue of ownership of approximately $15 million in interline freight balances owed by the Penn Central to interline carriers at the time of its bankruptcy petition and for which sums the Penn Central declined to honor sight drifts drawn on its account. The Third Circuit majority, in analyzing the status of interline freight balances under "common law trust principles" (486 F.2d at 524), found that a trust relationship was indeed manifested by the industry's interline freight balance settlement procedures.

The court, relying on the Restatement definition of a "trust" as "a fiduciary relationship with respect to property . . . which arises as a result of a manifestation of an intention to create it," [6] found that the facts and circumstances surrounding the industry's interline freight balance settlement procedures emphatically demonstrated

---

[6] A trust is defined in Restatement (Second) of Trusts § 2 (1957) as:

> [A] fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

an objective manifestation of intent to establish a trust relationship with respect to interline freight balances. In so concluding, the court found it significant that the funds were collected by one railroad (Penn Central) "as an agent of money due and owing the other railroads" (*Id.* at 523) and that there was no provision for the payment of interest by the collecting carriers which would ordinarily be the case in a debtor-creditor relationship (*Id.*). The Court also found that the fact that the Penn Central was permitted to commingle freight charges collected on other interline railroads' behalf with Penn Central's general revenues did not indicate the absence of a trust relationship in the context of the "unique and complex" interline railroad system. As stated by the Third Circuit:

> Commingling of monies has minimal significance in the extraordinary operations of interline railroads. That Penn Central is not, as a destination carrier, required by other carriers to immediately segregate funds collected does not necessarily reflect any intention to establish a debtor-creditor relationship in the face of the unique and complex interline railroad system. Normal operation conditions with innumerable daily collections of various categories preclude practically and economically any effective daily segregation. Burlington Northern Railway alone has more than 1300 stations from which waybills are issued. This is not a simple situation of one party receiving money clearly designated as payment for services performed by another. When a carrier collects funds for another railroad, it does not immediately know what portion of the revenues collected is to be allocated to other carriers.
>
> . . . We recognize the enormous difficulties confronting the destination carrier to correlate each of these waybills with payments received on a monthly basis, not to mention daily basis, and to segregate funds received according to the waybills.

Id. at 525.

The court also noted that the "AAR [settlement] rules merely serve to evidence the necessities of the situation." *Id.* As noted by the Court:

> To accommodate the carriers in this exceedingly voluminous and complicated accounting system, the AAR rules require that the statements be rendered only once each month and give the carriers 18 days to prepare the abstracts of the interline freight accounts after the end of the month in which the waybill is received.[7] The rules also indicate the difficulty in the segregation of collections. They require that accounts may be drawn on the collecting carrier after the specified period even though in some instances the charges have not yet been collected from the shippers.

Id.

"Accommodating and applying traditional common law trust principles to the unique regulatory scheme and accounting policies used by the nation's railroads (*Id.* at 524)," the Third Circuit majority concluded "that transportation and freight charges, *when collected*, are held in trust" for the interline railroads (emphasis in the original) and that the interlines are "entitled to have their monies." *Id.* at 524. Such result, the court also noted, was not only consistent with the "recognized trust and pragmatic considerations" discussed in its decision, but also "supports the congressional policy encouraging interline rail transportation of freight . . . nationwide." *Id.* at 527.

The concurring opinion of Judge Adams (joined by Judge Weis) in *Penn Central* was even more emphatic

---

[7] Effective January 1, 1983, AAR rules provide for forwarding of the abstracts by the 12th working day (rather than the 18th calendar day as formerly required) after the end of the month in which the waybill is received. Similarly, the abstracts must be received by the 14th working day after the end of the month (rather than by the 20th calendar day as was formerly required).

with respect to the propriety of treating interline freight balances as trust funds in railroad bankruptcy proceedings. Treatment of such funds as property of the interline railroads, Judge Adams found, is absolutely essential to ensure the efficient functioning of the national rail transportation network and such funds should be accorded "trust" status based on requirements of the national rail transportation system standing alone.[8] As found by Judge Adams:

> Congress has long been concerned with the establishment and maintenance of a viable national rail system. In part, this concern is manifested in legislation tailored to encourage and facilitate "interline" rail transportation of freight and passengers [statutory citations omitted]. To resort, as the majority does, primarily to "traditional common law trust principle" to resolve this case is to overlook these pertinent statutes. . . .
>
> * * *
>
> There is no statutory compulsion for interconnecting rail carriers to utilize any particular method of collecting fares and freight charges for a through-routed shipment. But, as a practical matter, only one such method is feasible. That is for a single carrier—either the originating or the destination carrier—to collect the entire fare, and then remit to interline carriers their pro rata portions. This arrangement is apparently subscribed to by the entire industry, and is incorporated in the rules of the Association of American Railroads. A departure from this procedure—for example, insistence by each interline carrier upon immediate payment by the

---

[8] Judge Adams specifically agreed with the majority's analysis that a trust relationship had been established on the facts of *Penn Central*. *Id.* at 532-33. The analysis set forth in his concurring opinion was intended to obviate "the possibility that, in another case, the *absence* of any of the traditional indicators of a trust relationship" would require a contrary holding to the majority decision. *Id.*

> shipper—might well undermine the entire system of interline rail transportation. At a minimum, it would greatly impede the smooth and efficient functioning of the through route network.

Id. at 531-532.

Judge Adams accordingly concluded that interline freight balances should be considered a *sui generis* matter in railroad bankruptcy proceedings and that the preferred position of interline railroads with respect to such funds should be guaranteed as a matter of federal bankruptcy law without the necessity of a common law trust analysis. As concluded by Judge Adams:

> Rather than merely invoking the hoary principles of trust law to settle this case, I would treat the problem of interline freight and passenger accounts as a *sui generis* matter. Having perceived Congress' intent in creating and maintaining a viable interline rail system, it would be appropriate to hold that, even in the *absence* of anything formally resembling a "trust," the interlines are entitled to a preferred position with respect to freight and passenger revenues owed them by a railroad in reorganization.

Id. at 533.

The reasoning of the Third Circuit in *Penn Central*, as set forth in both the majority opinion and concurring opinion of Judge Adams, was followed by the Sixth Circuit in the *Ann Arbor* case. In *Ann Arbor*, the issue was identical to that raised in *Penn Central*: whether pre-bankruptcy interline freight balances in the possession of a bankrupt carrier were the property of the interline carriers on whose behalf the funds were collected or were property of the bankrupt's estate that must be made available to the bankrupt's general creditors. The Sixth Circuit, specifically noting Judge Adams' finding that "the very existence of the national rail transportation system is dependent upon the interconnecting rail

service" (623 F.2d at 482), emphatically endorsed the "trust" rule established in *Penn Central*:

> We are persuaded by the reasoning of the court in the Trust Funds Case [*Penn Central*] and the concurring opinion of Judge Adams in which Circuit Judge Weis joined. . . . There was only temporary commingling of the funds which accounts for the reason that no res existed. . . . Furthermore, there was no intent to establish any debtor-creditor relationship and no interest was payable on the commingled funds. . . . Actually, no equities exist in favor of the Trustee. We find no logic in the contention that one bankrupt railroad may retain funds belonging to another interline railroad, whether or not in bankruptcy, which the collecting carrier was required to pay under the established practice and procedure required by the Interstate Commerce Commission, the Regional Rail Reorganization Act and the rules of the Association of American Railroads.

Id. at 482.

C. *The Decision of the Seventh Circuit Below Treating Interline Freight Balances as "General, Unsecured Debts" of the Bankrupt Conflicts with the Third and Sixth Circuit Decisions and Will Create Serious Problems for the Railroad Industry if Not Reversed*

In rejecting the claim of the Iowa Railroad Trustee in the instant case that the approximately $1.4 million in interline freight balances due the petitioning railroads (and the approximately $2.6 million in interline freight balances due other interlining railroads) should be treated as mere unsecured debts of the Iowa rather than as trust funds (to the extent still in the possession of the Iowa),[9]

---

[9] The district court found that approximately $2.8 million in funds in the possession of the Iowa at the time of its bankruptcy petition was attributable to freight charges collected by the Iowa on behalf of interline carriers. In addition, the district court imposed a trust on certain locomotives and other assets of the Iowa

the district court below relied squarely on the Third Circuit decision in *Penn Central* (particularly the concurring opinion of Judge Adams) and the Sixth Circuit decision in *Ann Arbor*. The district court thus found that Iowa Railroad "simply acted as a collection agent for Union Pacific due to exigencies of the interline freight revenue process" and that the "facts weigh against the existence of a debtor/creditor relationship respecting [Iowa] and these monies." Pet. App. at 42a. The district court further noted that the treatment of the interline freight balances as trust funds should not be solely dependent on whether the "traditional requisites of a trust are present" but rather should turn on the fact that the interlines should be held entitled to a preferred position with respect to interline funds in the interest of ensuring the integrity of the interline rail system. Pet. App. at 43a-44a. As concluded by the district court:

> There is simply no sensible argument that can be made that these interline freight revenues are property of IRRC. Principles of common sense and elemental justice require that the railroad which earned this money be declared to be its owner. Union Pacific should not be relegated to the status of a mere general creditor hoping to share some small portion of the money it earned with its capital and its labor. Rather, Union Pacific is entitled to be treated as a beneficiary with respect to these interline freight revenues which I hold are trust funds in the hands of IRRC.

Pet. App. at 44a.

In reversing the district court in its decision below, the Seventh Circuit rejected the lower court's reliance on "principles of common sense and elemental justice" and emphasized that the rights of the interline railroads

---

that were purchased with interline freight revenues. Pet. App. at 40a, 49a.

to the freight balances at issue "turns on property rights, not notions of equity" (Pet. App. at 4a).[10] The Seventh Circuit then found that the interline railroads had "three possible sources of property rights: federal statutory law, federal interests sufficiently strong to demand creation of federal common law, and state law" (Pet. App. 9a).[11] After finding that neither the Interstate Commerce Act nor regulations of the Interstate Commerce Commission specifically required the treatment of interline freight balances as trust funds (Pet. App. 10a-11a), the Seventh Circuit turned its attention to whether the federal interests at stake warranted the treament of interline freight balances as trust funds as Judge Adams' concurring opinion in *Penn Central* and the Sixth Circuit in *Ann Arbor* had found.

Based on its independent assessment regarding the economic interests at stake and the potential impact upon the national rail system of failing to accord connecting carriers a property right in interline freight balances earned through their interline operations, the Seventh Circuit expressly rejected the conclusions reached by the Third and Sixth Circuit opinions that "the federal interest in a unified national rail system required interline balances to be treated as trust funds." Pet. App. 9a. In so doing, the Seventh Circuit found it "at most a question of convenience" should failure to treat interline

---

[10] The Seventh Circuit also found that the interline railroads had no special equitable claim to the interline balances at issue on the ground that the trade creditors of the Iowa, just as the interline carriers, "contributed essential ingredients of the movement of the freight and earned their right to payment." Pet. App. at 4a.

[11] The Seventh Circuit found that no provision of the Bankruptcy Code (which was overhauled in 1978 subsequent to the *Penn Central* decision) specifically dealt with the status of interline freight balances. The Seventh Circuit therefore found that whether such balances constituted trust funds must accordingly be determined by the governing law in existence prior to the 1978 Bankruptcy Code. Pet. App. 4a-9a.

balances as trust funds lead railroads to bill customers separately (Pet. App. 12a) and further noted that the interline carriers' risk of nonpayment was "small" and could be protected against without separate billing. As found by the Seventh Circuit:

> Railroads need security, not complete assurance. The system of interline *balances* assures payment of most debts automatically: the Iowa "pays" the Union Pacific by providing transportation services when the Union Pacific is the originating carrier. Only the nets become debts. The risk railroads take is a correspondingly small portion of their revenues.
>
> Railroads have ways to deal with the risk of default by collecting carriers on the balances remaining after the automatically setoffs. One is to scrutinize the credit-worthiness of their trading partners, just as firms ordinarily do. . . . Collecting carriers with shaky finances may be required to post bonds, secure letters of credit, or find other ways to assure that they turn over receipts to the railroads that provide part of the transportation. The economy teems with such devices. . . .

Pet. App. at 13a. The Seventh Circuit also noted that there are other industries which rely upon interline transfers (*e.g.*, the airline industry and the motor carrier industry) and that "in none of these businesses are sums paid to the originating carrier treated as trust funds for the subsequent carriers." Pet. App. 14a.[12]

With respect to whether the requisites of an express or implied trust relationship were established by the

---

[12] The Seventh Circuit specifically noted that, unlike rail carriers, no statute requires air carriers to enter into interline agreements with other air carriers. Pet. App. 14a. The Seventh Circuit failed to note, however, that unlike rail carriers, who are required to enter into through arrangements with other rail carriers, a motor carrier of property may refuse to enter into a through arrangement with a motor carrier that is delinquent in its interline settlements. 49 U.S.C. 10705(h).

interline freight settlement procedures used by the Iowa and its connecting lines in the instant case, the Seventh Circuit found that the issue was a question of state law rather than "general common law" (which the court deemed consistent with the Third Circuit's analysis in *Penn Central*)[13]. The Seventh Circuit, however, in resorting to the identical analysis under the Restatement trust principles as made by the Third Circuit in *Penn Central*, found that *no* trust relationship could be implied because, unlike the facts in *Penn Central*, the Iowa paid by the "bill and voucher" methed rather than through the use of sight drafts. As found by the Seventh Circuit:

> We are sympathetic to the contention that the AAR's accounting rules, coupled with the system of sight drafts that give creditor lines effective dominion over the funds, is the practical equivalent of a declaration of trust. The trouble from the interline creditors' perspective is that the Iowa did not participate in the AAR's system for more than a few months. During the period at issue in this case it used the bill-and-voucher system, under which interline railroads had no more control over payment than did the Iowa's suppliers of diesel fuel.

Pet. App. at 19a-20a.[14]

---

[13] In *Penn Central*, however, the Third Circuit looked to "traditional common law trust principles" as a matter of *federal* law to determine whether a trust relationship existed. 486 F.2d at 524; *see also, In re Lehigh and New England Ry. Co. (Appeal of Central Jersey Indus., Inc.)*, 657 F.2d 570, 576 (3d Cir. 1981) (noting that issues involving the settlement of interline freight accounts "implicate wholly national concerns and therefore should be governed by federal law").

[14] The Seventh Circuit also noted that "when billed, [the Iowa] paid slowly (60-90 day delays were common)" and that other railroads apparently did not protest the slow payment. Pet. App. at 20a. The Seventh Circuit, however, viewed these facts as illustrative of the "bill and voucher" system rather than as outcome-determinative in themselves (*i.e.*, as demonstrating "laches"); its

The Seventh Circuit also rejected the possibility that a "constructive trust" existed, finding no "unjust enrichment" on behalf of the Iowa's trade creditors. As found by the court:

> There could be a decent claim of unjust enrichment if we had to decide whether the Iowa's stockholders or the interline railroads should get the money remaining in the Iowa's coffers; it would unjustly enrich the stockholders to receive this money. But that is not the problem. The question is whether the interline railroads get all of the money and the suppliers of diesel fuel (and tort creditors) none, or whether all creditors share the inadequate funds. . . . All of the Iowa's creditors have supplied valuable goods and services; all have been stiffed. No case of which we are aware employs the idea of the "constructive trust" to settle priorities among bona fide business suppliers. . . .

Pet. App. at 22a.

As is apparent, the Seventh Circuit decision directly conflicts with the reasoning and conclusions of the Third and Sixth Circuits with respect to the trust status of interline freight balances and in so doing turns estab-

---

decision denies trust status to *all* interline freight balances settled under the "bill and voucher" method regardless of the regularity of the settlement period. Indeed, the *per se* treatment accorded the "bill and voucher" settlement method is highlighted by the Seventh Circuit's reference in its decision to *Southern Ry. v. United States*, 306 F.2d 119 (5th Cir. 1962). Pet. App. at 20a. In *Southern Ry.*, a case cited by the *Penn Central* majority as supporting its trust analysis (486 F.2d at 525-26), the Fifth Circuit in fact *agreed* with the petitioning interline railroad that the interline freight balances at issue "acquire[d] a 'trust' character" when collected and mingled (306 F.2d at 125), but found, apparently on a laches theory, that because the carrier had waited for over a year to demand payment, the interline balance claim was not "entitled to preference" over certain tax claims. *Id.* In contradistinction to *Southern Ry.*, the Seventh Circuit in the instant case denied "trust" status to the interline balances at issue *ab initio*.

lished law, policy and equitable considerations on their head. In addition, the Seventh Circuit's attempt to belittle the impact of its decision on the railroad industry is totally unsound.

First, although the Seventh Circuit attempts to distinguish its holding on the ground that the "bill and voucher" settlement method was used in the instant case rather than the "sight draft" method employed in *Penn Central*, the purported distinction between the two cases is essentially makeweight. There is no escaping the fact that, rather than predicating the existence of a common law trust relationship on the facts that the Iowa Railroad was acting as "an agent of money due and owing the other railroads;" that no interest was charged the Iowa on funds collected and retained for other railroads as would imply a debtor/creditor relationship; and that the Iowa could not as a practical matter be expected to segregate the freight charges collected on behalf of other railroads in the context of the interline railroad system (factors which the Third Circuit expressly relied upon in finding a trust relationship (468 F.2d at 523)), the Seventh Circuit instead seeks to impose, at a minimum, the *additional* general requirement that the interline railroads be concomitantly provided "effective dominion" over the interline freight balances before a trust relationship may be implied. Such requirement, which assigns to unprotected status the over $46 million per month in *net* interline revenue payable to Class I railroads through the "bill and voucher" settlement method, simply cannot be squared with either the rationale used by the *Penn Central* majority or with general trust principles.

There is absolutely no requirement under established trust principles that a trust relationship be predicated on a finding that the beneficiary of a trust possess "effective dominion" over the funds held in trust. Indeed, as the Third Circuit majority decision itself notes, Penn Central never in fact parted with ultimate dominion over

the interline funds it collected: *Penn Central stopped payment* on the sight drafts drawn by the other interline carriers when presented. The Seventh Circuit's reasoning, as well as its effective dismissal of the other supporting grounds relied upon by the *Penn Central* majority in finding a trust relationship, thus strike at the very foundation of the *Penn Central* decision and cast in uncertain light not only the status of interline freight balances settled under the "bill and voucher" method, but also those settled under the "sight draft" system (the "trust" status of which the court, although terming itself "sympathetic", effectively reopened as an unsettled question.

Second, with respect to the policy issues presented, the Seventh Circuit, rather than finding that interline freight balances should be treated as trust funds in the interests of ensuring the viability of the unitary national rail system as the concurring opinion of Judge Adams in *Penn Central* and the Sixth Circuit decision in *Ann Arbor* held, expressly found that such policy considerations were *insufficient* to require the imposition of a trust relationship as a matter of federal common law. In so holding, as the Seventh Circuit itself specifically notes, it is in direct conflict with the opinions cited. Pet. App. at 9a, 13a.

Indeed, the Seventh Circuit's attempts to dismiss the overriding policy arguments supporting the imposition of a trust relationship as a matter of federal common law not only create an express conflict in the circuits on the issue, but also serve to clearly indicate the deficiencies of the Seventh Circuit's reasoning. It is simply incomprehensible for the Seventh Circuit to have concluded, as it did, that the absence of a system of unitary billing for interline movements "is at most a question of convenience." Pet. App. at 12a. The sheer volume of additional paperwork that would be required, as well as the necessity of each carrier ensuring the actual payment to it of

"pre-paid" charges at each junction point involved, has the potential to create not only complexity, but also havoc in interline scheduling. In fact, the Seventh Circuit does not even so much suggest in its opinion how the national rail system, which is effectively unique in that its "very existence . . . is dependent upon the interconnecting rail service (*Ann Arbor*, 623 F.2d at 482)" could even begin to function efficiently should all carrier participants to an interline movement insist on separate billing. Indeed, as other courts who have examined the issue have correctly concluded, the unitary billing system for interline freight accounts presents a "convenience so great as to be imperative. . . ." *Atlantic Coast Line R. Co. v. Pennsylvania & Co.*, 12 F. Supp. 720 (E.D. Pa. 1935), quoted in *Penn Central* (Adams, concurring), 486 F.2d at 532, n. 7.

In addition, the Seventh Circuit's suggestions for alternative "security" arrangements that could be adopted by carriers for interline freight balances in the absence of trust treatment of such funds is similarly shortsighted. At bottom, all such arrangements must reflect the absolute statutory requirement that rail carriers, unlike air or motor carriers, *must* deal with connecting carriers in establishing through routes (49 U.S.C. 10705 (a)(1)) and that an individual carrier cannot simply insist on particular "security" arrangement that it deems most beneficial to its interests: a recalcitrant carrier can effectively insist on separate billing based on its statutory right to participate in a through movement. In the absence of the imposition of a trust relationship between the collecting carrier and the other interline participants, therefore, the system for settlement of interline freight balances would likely be far more complex—and potentially far less efficient—than the system currently in place.

Finally, the Seventh Circuit's conclusion that there would be no "unjust enrichment" should interline freight

balances in the possession of the Iowa be made available for the benefit of the Iowa's general creditors—and therefore no predicate upon which the court could impose a "constructive" trust on behalf of the interline carriers that earned the revenues—totally reverses the equities presented. The Iowa Railroad and its connecting carriers do not lose their status as wholly independent carriers incurring wholly distinct commercial obligations for their respective portions of the interline freight movements performed on behalf of shippers. There simply is no basis whatsoever—particularly an *equitable* one as the Seventh Circuit found—for considering that a general creditor of the Iowa—who only supplied the Iowa with fuel and equipment—would have an equal claim to interline funds earned by the Iowa's connecting carriers —for which the connecting carriers expended *their own* fuel and resources and to which they would indisputably be legally entitled in the absence of the Iowa's bankruptcy—for the settlement of the *Iowa*'s debts. The general creditors have no more "equitable" claim to interline freight balances in the hands of a bankrupt carrier at the time of its bankruptcy petition than they would if they attempted to obtain such funds after settlement directly from the interline roads who earned them—a claim of "equitable" entitlement that can only be viewed as outrageous.

Indeed, the Seventh Circuit's position regarding the equities of according trust status to interline freight balances has been flatly rejected by both the Third and Sixth Circuits. As found by the *Penn Central* majority:

> The AAR interline accounting system is in essence . . . a system by which one railroad collects monies owed by shippers to both itself and other railroads. The monies collected belong only in part to the collecting railroad; as to monies owed other railroads, the collecting railroad serves merely as a receiving and transmitting agent. A common sense interpre-

> tation of this system would indicate that funds collected by one railroad for and in behalf of another railroad are held in trust by the collecting railroad until the monies are transmitted. . . .

486 F.2d at 523-24. As also flatly concluded by the Sixth Circuit in *Ann Arbor* in rejecting the Trustee's argument that pre-bankruptcy interline freight balances should be made available to the bankrupt's general creditors: "[N]o equities exist in favor of the Trustee. . . ." 482 F.2d at 482.

Because the Seventh Circuit's denial of trust status to interline freight balances collected by one railroad on behalf of another is contrary to sound considerations of law, policy and equity, departs from settled practice and has the potential to cause serious disruption to the efficient functioning of the national rail system, the Seventh Circuit's decision warrants reversal by this Court. In addition, because the decision below directly conflicts with decisions of the Third and Sixth Circuits treating interline freight balances as trust funds as a matter of federal law, review by this Court is necessary to ensure a uniform federal rule regarding the status of interline freight balances. As specifically found by the Third Circuit, "[i]t is manifest that uniformity is required in the manner and means by which interline freight accounts are balanced." *In re Lehigh and N. E. Ry. Co.*, 657 F.2d 570, 575 (3rd Cir. 1981).

CONCLUSION

For the foregoing reasons the Court should grant the petition for certiorari.

Respectfully submitted,

THOMAS C. DORSEY
The American Short Line
Railroad Association
2000 Massachusetts Avenue, N.W.
Washington, D.C. 20001
(202) 785-2250

J. THOMAS TIDD
KENNETH P. KOLSON *
Association of American
Railroads
50 F Street, N.W.
Washington, D.C. 20001
(202) 639-2511

August 15, 1988

* Counsel of Record